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No. 163

In the Supreme Court of the United States

OCTOBER TERM, 1932

ATLANTIC CITY ELECTRIC COMPANY, PETITIONER

v.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 12–19) is reported in 15 B. T. A. 1084. The opinion of the Circuit Court of Appeals (R. 29–33) is reported in 57 F. (2d) 186.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered April 11, 1932. (R. 33.) The petition for a writ of certiorari was filed June 17, 1932. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Were the petitioner and the American Gas and Electric Company affiliated corporations during the years 1917, 1918, and 1919, within the meaning of Section 240 (b) (1) of the Revenue Act of 1918 and Section 1331 (b) (1) of the Revenue Act of 1921, when all of the petitioner's common stock, constituting 77 per cent of its total outstanding stock, was owned directly by the American Gas and Electric Company and the balance of its stock, being preferred stock with voting rights and redeemable at any time, was owned by outside interests?

STATUTES AND REGULATIONS INVOLVED

These are set forth in the appendix, pp. 11–13, *infra.*

STATEMENT

The findings of fact made by the Board of Tax Appeals (R. 13–15) may be summarized as follows:

During the taxable years 1917, 1918, and 1919, and for many years prior thereto, the American Gas and Electric Company was a holding corporation owning common stock in a number of lighting and power companies. (R. 13.) It had in excess of 3,000 stockholders. (R. 14.)

The petitioner is a public service corporation organized under the laws of New Jersey and engaged in the business of supplying light, heating, and power in and around Atlantic City, New Jersey. During the taxable years in question it had out-

standing 12,500 shares of common stock of $100 par value each, all of which were owned by the American Gas and Electric Company, and 3,702 shares of preferred stock, none of which were owned by the American Gas and Electric Company, although from 655 to 761 of such shares were owned by stockholders of the American Gas and Electric Company.[1] The common stock owned by the American Gas and Electric Company constituted about 77 per cent of the total outstanding common and preferred stock of the petitioner. Holders of the preferred stock were entitled to vote and such stock was preferred to the extent of an annual cumulative dividend of 6 per cent and on final liquidation. It was redeemable at any time and had no other interest in dividends above 6 per cent. (R. 13.)

In no instance during the years in question did any holder of preferred stock vote against or object to any action taken at any stockholders' or directors' meeting of the petitioner, nor against any proposition advanced by the American Gas and

[1] The stockholders in the American Gas and Electric Co. who owned some of the preferred stock in the petitioner must be taken as "outside interests." Obviously their holdings in the two corporations were not "in like proportions." Petitioner concedes that the case does not involve the question of ownership or control *by the same interests* (Br. 8), and the Board found (R. 14) that "the control and ownership exercised by the American Gas and Electric Co. resulted from its absolute ownership of the entire common stock of its subsidiaries and not from control or ownership of preferred stock by its stockholders."

Electric Company or its representatives, but voted in conformity thereto. Dividends on the preferred stock in the contract amount of 6 per cent were always paid promptly and there have never been any unpaid cumulative dividends. (R. 14.)

All financial matters and operations of the petitioner were conducted by and carried on through the American Gas and Electric Company and the major operations of the petitioner were carried on in the office of the American Gas and Electric Company at New York City. (R. 14.)

The respondent determined deficiencies against the petitioner for the taxable years in question on the basis of separate returns and refused to consolidate the returns of petitioner with those of the American Gas and Electric Company. (R. 13.) The Board of Tax Appeals held that the two corporations were affiliated and should file consolidated returns. (R. 16.) The Commissioner appealed (R. 29) and the Circuit Court of Appeals reversed the Board (R. 33).

ARGUMENT

The sole question is whether the American Gas and Electric Company owned or controlled, during the years 1917, 1918 and 1919, substantially all of petitioner's stock within the meaning of Section 1331 (b) (1) of the Revenue Act of 1921 and Section 240 (b) (1) of the Revenue Act of 1918, (*infra*, pp. 11–12).

The American Gas and Electric Company owned directly all of petitioner's common stock, which was only 77 per cent of its total outstanding stock. This was not "substantially all" within the meaning of the statute. In *Handy & Harman* v. *Burnet*, 284 U. S. 136, it was held that 76.66 per cent did not constitute "substantially all" and it has been held that 88 per cent (*Good Mfg. Co.* v. *Burnet*, 58 F. (2d) 685 (App. D. C.)), 85 per cent (*Burnet* v. *Bank of Italy*, 46 F. (2d) 629, 630 (C. C. A. 9th)), 77 per cent to 84 per cent (*United States* v. *Cleveland, P. & E. R. Co.*, 42 F. (2d) 413 (C. C. A. 6th)), 83⅓ per cent (*Jos. Denunzio Fruit Co.* v. *Commissioner*, 49 F. (2d) 41 (C. C. A. 6th)), and 80 per cent (*Wadhams & Co.* v. *United States*, 67 Ct. Cls. 235), did not constitute "substantially all" the stock of a corporation.

But the petitioner contends that the American Gas and Electric Company owned all the stock of the petitioner because it owned all the *common* stock of that company, and that the outstanding stock not owned by the American Gas and Electric Company should not be considered since it was all *preferred* stock with no interest in the earnings above annual dividends of 6 per cent. But the statutes involved refer to ownership or control of *stock* and make no distinction between preferred and common stock. The outstanding preferred stock here in question had voting privileges. (R. 13.) The applicable Regulations of the Treasury

Department (Article 633, Regulations 45 and 62, pp. 12–13, *infra*) have construed the statutes as referring to all outstanding *voting stock*. This interpretation has received legislative approval in Section 240 (c)(1) of the Revenue Act of 1924, c. 234, 43 Stat. 253, 288 (U. S. C., Title 26, Sec. 993) which section, in reenacting the statutes here involved, provides that two corporations are deemed affiliated "if one corporation owns at least 95 per centum of the *voting* stock of the other." (Italics ours.) The Report of the Committee on Ways and Means, referring to this provision, states (House Rept. No. 179, 68th Cong., 1st. Sess., p. 24):

> The requirement that the stock held must be "voting" stock merely embodies in the law the present rule of the Treasury Department.

See also Section 240 (c) and (d) of the Revenue Act of 1926, c. 27, 44 Stat. 9, 46 (U. S. C. Sup. V, Title 26, Sec. 993). Moreover, the cases hold that the earlier Acts related to voting stock. *Schlafly* v. *United States,* 4 F. (2d) 195, 200, 201 (C. C. A. 8th); *Ice Service Co.* v. *Commissioner,* 30 F. (2d) 230 (C. C. A. 2d); *United States* v. *Cleveland, P. & E. R. Co.,* 42 F. (2d) 413, *supra.* Cf. *Commissioner* v. *City Button Works,* 49 F (2d) 705 (C. C. A. 2d).

In *Howes Bros. Hide Co.* v. *Commissioner,* 49 F. (2d) 878 (C. C. A. 1st), the court held that where the same interests owned directly all the common stock of two corporations affiliation could not be

denied merely because outside interests owned a substantial block of voting preferred stock in one of the corporations. But that decision was reversed by this Court *per curiam* on the authority of its decision in the *Handy & Harman* case, *supra,* 284 U. S. 583.

Petitioner contends that the reversal by this Court in the *Howes Bros. Hide* case was because the same interests did not hold the stock of the corporations there involved in like proportions—a requisite which is established by the *Handy & Harman* decision, *supra.* It is true that the facts in the *Howes Bros. Hide* case do show that the same interests did not hold the shares of the corporations involved in like proportions, but that point was not discussed by the Circuit Court of Appeals in its opinion nor was it raised in the Government's petition for certiorari. In the *Howes Bros. Hide* case, as said by the Circuit Court of Appeals (49 F. (2d) 878, 880), "The main question is as to the minority holding of first preferred stock in the Howes brothers corporation," and the decision was based on that point. The Government's petition for certiorari dealt chiefly with that question as did likewise the brief in opposition. While the decision in the *Handy & Harman* case did not involve the precise question raised in the *Howes Bros. Hide* case or in this case, we are unwilling to assume, as urged by petitioner, that this Court reversed the *Howes Bros. Hide* case on a point not passed upon by the Circuit Court of Appeals and not raised in the petition for certiorari.

If the reversal was based upon the chief issue actually raised, that case disposes of all questions presented in this case.

The only other decision holding that voting preferred stock should not be taken into account in determining the application of the statutory provisions here involved is *Commissioner* v. *Shillito Realty Co.*, 39 F. (2d) 830 (C. C. A. 6th.) But, as pointed out in the later decision by the same court in *United States* v. *Cleveland, P. & E. R. Co.*, 42 F. (2d) 413, 419, *supra*, that case went off on its own peculiar facts. The latter case is in conformity with the decision below and, we submit, eliminates any conflict between the decision in the instant case and the rulings of the Sixth Circuit. In any event, the *Shillito* case was decided prior to this Court's decision in the *Howes Bros. Hide* case, *supra*, which, as stated above, apparently disposes of the question.

The petitioner contends further that even if preferred stock must be taken into account in determining the applicability of the statutory provisions here involved, the right of the American Gas & Electric Company to redeem the preferred stock of the petitioner at any time gave that company *control* over the preferred stock. But a "control of stock without title, beneficial ownership, or other legal means to enforce it" and resting only upon acquiescence, business necessities, or other considerations of no binding force is not sufficient to meet the requirements of the statute. *Handy & Harman* v. *Burnet*, 284 U. S. 136, *supra; Burnet* v. *J. Rogers*

Flannery & Co., No. 799, October Term, 1931, decided April 18, 1932; *Burnet* v. *Peavy-Wilson Lumber Co.,* No. 537, October Term, 1931, decided April 18, 1932. As pointed out by the court below, the right of the American Gas and Electric Company to redeem did not confer upon that company any legally enforceable control prior to the exercise of that right. The right to redeem is somewhat analogous to an option to buy or an agreement to first offer stock to the majority stockholders. Such rights, without more, are not sufficient to constitute control of the stock within the meaning of the statutes prior to the exercise of the option or right. *Peytona Lumber Co.* v. *Burnet,* 55 F. (2d) 27 (C. C. A. 4th), now pending before this Court on petition for a writ of certiorari, No. 133, October Term, 1932; *Wadhams & Co.* v. *United States,* 67 C. Cls. 235; *Carnie-Goudie Manufacturing Co.,* 18 B. T. A. 893. Moreover, it does not appear from the findings of the Board of Tax Appeals that the American Gas and Electric Company was in a position during the years in question to redeem the outstanding preferred stock.

In the *Howes Bros. Hide* case, *supra,* the outstanding preferred stock was subject to redemption after 90 days' notice. If, in reversing the decision of the Circuit Court of Appeals for the First Circuit in that case, this Court intended to pass upon the question of *control* arising out of the right to redeem the preferred stock, it has disposed of this contention of the petitioner.

We submit that the American Gas and Electric Company did not own or control substantially all of petitioner's stock as required by the statutes.

CONCLUSION

We submit that the principles applicable to this case have been settled by the decisions of this Court and that they were correctly applied by the Circuit Court of Appeals. Except for the question whether the right to redeem preferred stock gives control to the owners of the common stock, which we submit, was settled by *Handy & Harman, supra,* no question presented in this case can arise under any Revenue Act later than that of 1921. The questions presented are, therefore, not of present general importance. The petition should be denied.

Respectfully submitted.

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APPENDIX

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1921, c. 136, 42 Stat. 227, 319 (U. S. C., Title 26, Sec. 1067):

> SEC. 1331. (a) That Title II of the Revenue Act of 1917 shall be construed to impose the taxes therein mentioned upon the basis of consolidated returns of net income and invested capital in the case of domestic corportions and domestic partnerships that were affiliated during the calendar year 1917.
>
> (b) For the purpose of this section a corporation or partnership was affiliated with one or more corporations or partnerships (1) when such corporation or partnership owned directly or controlled through closely affiliated interests or by a nominee or nominees all or substantially all the stock of the other or others, * * *.
>
> (c) The provisions of this section are declaratory of the provisions of Title II of the Revenue Act of 1917.

Revenue Act of 1918, c. 18, 40 Stat. 1057, 1082:

> SEC. 240. (b) For the purpose of this section two or more domestic corporations shall be deemed to be affiliated (1) if one corporation owns directly or controls through closely affiliated interests or by a nominee or nomi-

nees substantially all the stock of the other or others, * * *.

Article 633 of Treasury Regulations 62, issued under the Revenue Act of 1921, provides:

> *When corporations are affiliated.*—Corporations will be deemed to be affiliated (a) when one domestic corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (b) when substantially all the stock of two or more domestic corporations is owned or controlled by the same interests. The words "substantially all the stock" can not be interpreted as meaning any particular percentage, but must be construed according to the facts of the particular case. The owning or controlling of 95 per cent or more of the outstanding voting capital stock (not including stock in the treasury) at the beginning of and during the taxable year will be deemed to constitute an affiliation within the meaning of the statute. Consolidated returns may, however, be required for any taxable year beginning prior to January 1, 1922, even though the stock ownership is less than 95 per cent. When the stock ownership or control is less than 95 per cent, but in excess of 70 per cent, a full disclosure of the affiliations should be made, showing all pertinent facts, including the stock owned or controlled in each subsidiary or affiliated corporation and the percentage of such stock owned or controlled to the total stock outstanding.

This information will also be required where like conditions exist and the taxpayer elects to file a consolidated return for any taxable period beginning on or after January 1, 1922. Such statement should preferably be made in advance of filing the return, but if a consolidated return is filed subject to the approval of the Commissioner, the required statement should be filed as a part of the return. The words "the same interests" shall be deemed to mean the same individual, partnership, or corporation, or the same individuals, partnerships, or corporations, but when the stock of two or more corporations is owned or controlled by two or more individuals, by two or more partnerships, or by two or more corporations, the corporations will not be held to be affiliated unless the percentage of stock of such corporations held by each individual, each partnership, or each corporation is substantially the same in each of the corporations.

Article 633 of Treasury Regulations 45, issued under the Revenue Act of 1918, is substantially the same as Article 633 of Treasury Regulations 62.

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